United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-7366

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P/S

United States Court of Appeals
FOR THE SECOND CIRCUIT

No. 75-7366

DON R. DASEKE, Et Al.,
Plaintiffs-Appellants,

vs.

ABRAHAM & CO., INC., Et Al.,
Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF PLAINTIFFS-APPELLANTS DON R. DASEKE, ET AL.

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Statement of Issue on Appeal

Did the court err in granting the motion of the defendants Abraham & Co., Inc. and Joseph A. Gottlieb for an order staying prosecution of the instant federal litigation pending completion of arbitration proceedings pending before the American Arbitration Association.

Statement of the Case

This case involved a claim by the plaintiffs for damages arising under the Securities Exchange Act of 1934, as amended, 15 U.S.C. §78a, *et seq.* (the "1934 Act") and the Rules and Regulations promulgated thereunder, particularly Sections 6, 7, 10(b), 19, 20 and 29, 15 U.S.C. §§ 78f, 78g, 78j(b), 78s, 78t and 78cc; SEC Rules 10b-3, 10b-5; Regulation T issued by the Board of Governors of the Federal Reserve System, 12 C.F.R. §220, ("Reg. T") and the laws and statutes of the State of New York. The plaintiffs, constituting two investment partnerships, opened margined option writing accounts, with orders to be executed by the defendant Abraham & Co., Inc., subject to all applicable rules, regulations, customs and usages of the New York Stock Exchange and the Chicago Board of Options. Despite the fact that Abraham was executing the orders on the margined accounts, the orders were actually placed with Merkin & Co., Inc. and two of the individual defendants in this litigation, Julius Cherny and Carl Slove, were at the time employees of Merkin. Confirmations received from Abraham always bore the legend: "Upon instructions of Merkin & Co., Inc." Monthly statements received by the plaintiffs from Abraham always were imprinted with the legend: "Carried by arrangement with Merkin & Co., Inc."

Plaintiffs have alleged that defendants directly violated Regulation T by failing to notify the plaintiffs when the option accounts went into an undermargined status, by failing to provide the plaintiffs with current information concerning that status, and by permitting the plaintiffs to transact in the accounts. Additional violations of Regulation T are alleged, together with violations of New York Stock Exchange Rule 431 and violations of sections of the 1934 Act, rendering void the customer agreements between

the parties. Plaintiffs' further allege that the acts of the defendants were manipulative and deceptive devices whose purpose was to defraud the plaintiffs in violation of Section 10(b) of the 1934 Act. The plaintiffs claimed $500,000 damages and punitive damages in the sum of 1,000,000. After the institution of this action in United States District Court for the Southern District of New York, the defendants Abraham and Gottlieb moved for an order staying further prosecution of the action by the plaintiffs, pending completion of arbitration proceedings, alleged to involve identical issues, before the American Arbitration Association.

The parties appear to be in agreement that the following events took place on the dates as set forth:

In May of 1974 a dispute arose between the parties as to the proper handling of the margined accounts. On May 29, 1974 Don Daseke in behalf of both plaintiff partnerships, advised the defendant Abraham that he would seek remedy by way of an action for damages (81A*). Almost a full month later, on June 20, 1974, Abraham notified Daseke that it required additional margin from him. The letter concluded as follows: "In the event you fail to furnish us with sufficient funds to either discharge your margin debts or properly margin your accounts by Friday, June 28, 1974, we shall proceed to enforce our rights against you by submitting this matter to arbitration. If arbitration becomes necessary, the choice of forum shall be ours to make unless you make the selection by notification to us by registered mail on or before June 28th" (82A). In response to what he considered to be the threat contained in the aforesaid letter, Daseke on June 26, 1974 advised the American Arbitration Association that he would select that organization as the arbitration medium (83A).

* References to "A" are to the Joint Appendix.

On July 1, 1974 Abraham instituted arbitration against the plaintiffs (37A *et seq.*) and on July 12, 1974 the plaintiffs demanded arbitration of specific claims against Abraham and other defendants (36A *et seq.*).

The arbitration instituted by the plaintiffs included Merkin & Co., Inc. as a defendant along with Abraham & Co., Inc. However, Merkin refused to participate in the arbitration and instituted an action in the state courts of New York for an order staying the arbitration as to Merkin on the basis of a claim that Merkin was not a signatory to the customer's agreement and was therefore not bound by its arbitration clause. Plaintiffs thereafter served Merkin with a subpoena duces tecum in order to determine the relationship between Merkin and Abraham with respect to the plaintiffs' accounts. Merkin applied for an order quashing the subpoena on the grounds that the requested information was confidential.

Faced with Merkin's continued resistance to arbitration discovery, plaintiffs ceased all arbitration efforts and initiated this action in order to bring all the parties before the same tribunal. Without control over both Merkin and Abraham in one forum, and without the availability of effective discovery, arbitration appeared fruitless.

Subsequently, on November 19, 1974 the plaintiffs notified the American Arbitration Association that they were withdrawing the arbitration against Abraham and others, having just instituted the instant litigation in the United States District Court (65A). Abraham responded on November 22, 1974 that it would oppose the efforts of the plaintiffs to withdraw the matters from arbitration (66A). Thereafter, Abraham and Gottlieb filed the instant motion to stay and the motion was granted by the United States District Court (Judge Wyatt) on June 13, 1975 (121A).

ARGUMENT

I.

The Policies Underlying The Securities Laws Require Judicial Resolution Of The Present Dispute.

A. Protection of the Securities Investor.

The Supreme Court of the United States in *Wilko* v. *Swan,* 346 U.S. 427 (1953) held that the federal policy favoring arbitration must be subordinated to the overriding federal concern for protection of securities investors. The Supreme Court ruled that an investor should not be able to waive his right to the protections afforded by the federal securities law through an arbitration agreement.

The *Wilko* decision was based on the Congressional policy to protect investors against possible loss of rights granted by the federal securities laws. "[T]he purpose of Congress was to assure that sellers could not maneuver buyers into a position that might weaken their ability to recover under the Securities Act." 346 U.S. at 432. The Court feared a brokerage house with its superior bargaining power could force the investor to forfeit his rights and thus defeat the purpose of the securities laws. See ***Axelrod & Co.*** v. *Kordich, Victor & Neufeld,* 451 F.2d 838, 842 (2d Cir. 1971).

The considerations which prompt the *Wilko* holding are most compelling in this litigation. Plaintiffs' complaint involves many complex and controversial legal issues. Liberal discovery will be essential to unearth all the facts surrounding the Merkin-Abraham relationship and Abraham's margin records. Experience to date has indicated that a necessary party, Merkin, will not submit to arbitration. An arbitrated result could be contrary to the public policy which favors private actions to punish margin violations as an important element of the regulatory mechanism.

Courts must be cautious when asked to find that an investor has waived his right to a federal forum, especially in situations such as the present where there is no written agreement to arbitrate an *existing* controversy, but instead an agreement is being implied from the conduct of the parties. Here plaintiffs' preliminary administrative actions in response to Abraham's demand for arbitration did not constitute an agreement to arbitrate. Plaintiffs did not waive their rights to proceed in federal court.

B. Regulation of Broker-Dealer Margin Violations.

Plaintiffs' private interests in proceeding and recovering against defendants are important. But equally important is the broad public interest in regulating extensions of credit in securities transactions.

The courts have recognized that a civil action for violation of Federal Reserve Board regulations promulgated under Section 7 of the Securities Exchange Act of 1934 serves two purposes: first, to reimburse the investor for damages caused by the broker's violation and second, to regulate the violations of the margin provisions by brokers and dealers. *See Serzysko* v. *Chase Manhattan Bank,* 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd. mem.,* 409 F.2d 1360 (2d Cir. 1968), *cert. denied,* 396 U.S. 904 (1969); *Pearlstein* v. *Scudder & German,* 429 F.2d 1136 (2d Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971). "[I]t has been recognized in numerous cases . . . that private actions by market investors are a highly effective means of protecting the economy as a whole from margin violations by brokers and dealers." 429 F.2d at 1140.

The second consideration is a vital Federal policy which permeates all private actions for margin regulations. The basis for the policy was aptly summarized in a recent East-

ern District of Pennsylvania decision. *Jennings* v. *Boenning & Co.*, 388 F. Supp. 1294, 1299 (E.D. Pa. 1975):

> ". . . The purpose of Section 7(c) of the Securities & Exchange Act and Regulation T is to reduce the amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry. Among the prime purposes of the Act and the Regulation is the control of inflation, which is and has been a threat to our nation's economy. The protection of the investor is also a subsidiary but important purpose. To police this law, private actions apply a deterrent effect above and beyond threats of Governmental action by the Securities and Exchange Commission. . . ."

Such an overriding public interest alone has been held to be sufficient justification for holding that an arbitration agreement cannot constitute waiver of a plaintiff's right to proceed in federal court. *American Safety Equipment Corp.* v. *J. P. Maguire & Co.*, 391 F.2d 821 (2d Cir. 1968). The *Maguire* court held that the right to litigate an antitrust violation could not be waived by prior agreement to arbitrate. In language which closely parallels that found in the above cited margin violation cases, the Second Circuit stated that antitrust violations were not mere private matters and that a plaintiff asserting an antitrust claim was acting as a pritave attorney general protecting the public interest. The federal policy of encouraging private enforcement suits was found to outweigh the federal policy favoring arbitration. *See also Cobb* v. *Lewis*, 488 F.2d 41 (5th Cir. 1974).

A central issue in this case is defendants' violation of Reg. T. To hold that plaintiffs waived their right to sue in federal court would penalize the interest of the public as

a whole that the margin rules be strictly enforced. Public policy demands that a waiver of the exclusive jurisdiction of the Federal courts over causes of action arising under the federal securities laws be found in only the clearest of circumstances.

II.

Arbitration Is Not The Appropriate Forum For The Present Controversy.

A. Arbitration Panels Are Not Equipped To Pass Upon Complicated Legal Issues.

An important consideration in the *Wilko* decision was the Supreme Court's recognition that arbitrated results are rarely precise. "Even though the provisions of the Securities Act, advantageous to the buyer, apply, their effectiveness in application is lessened in arbitration as compared to judicial proceedings." 346 U.S. at 435. The well-known propensity of arbitration panels to find a "middle" ground makes the forum a poor one in which to adjudicate violations of the federal securities laws.

The major shortcoming of arbitration in the context of violations of federal securities laws is that arbitration panels by their nature are not structured to apply complicated legal principles or to enforce federal public policy. Arbitration panels are more suited to determine *factual* disputes than complex *legal* questions. As the Court in *Wilko* v. *Swan, supra,* stated:

> "Determination of the quality of a commodity or the amount of money due under a contract is not the type of issue here involved. This case requires subjective findings on the purpose and knowledge of an alleged violator of the Act. They must be not only deter-

> mined but applied by the arbitrators without judicial instruction on the law. As an award may be made without explanation of their reasons and without a complete record of their proceedings, the arbitrators' conception of the legal meaning of such statutory requirements as 'burden of proof,' 'reasonable care' or 'material fact,' . . ., cannot be examined." 346 U.S. at 435-36.

Accord, Reader v. *Hirsch & Co.,* 197 F. Supp. 111 (S.D.N.Y. 1961).

This shortcoming is especially relevant in the instant case. The Complaint alleges violations of Reg. T, a complex regulation whose application to a particular set of facts involves many controversial and still unsettled areas of law. Plaintiffs' allegations of violation of Rule 10b-5 also involve complex and unsettled legal issues, including knowledge, reliance and scienter.

If compelled to arbitrate, plaintiffs would have little protection if the arbitrators misapplied the law. Only in the clearest instances of misapplication of the pertinent law will an arbitrator's findings be set aside. As the Court in *Wilko* v. *Swan* explained:

> "In unrestricted submissions, such as the present margin agreements envisage, the interpretations of the law by the arbitrators in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error in interpretation. The United States Arbitration Act contains no provision for judicial determination of legal issues such as found in the English law." 346 U.S. at 436-37.

Since the outcome of the present controversy will be greatly affected if not determined by the selection and application of pertinent law, it is singularly inappropriate that this dispute be submitted to arbitration.

B. The Discovery Available In Arbitration Proceedings Is Inadequate For This Case.

Arbitration allows only very limited discovery. Courts have held that the broad discovery available under the Federal Rules is not to be used in arbitration, that it is both superfluous and incompatible with such a proceeding. *Foremost Yarn Mills, Inc.* v. *Rose Mills, Inc.*, 25 F.R.D. 9 (E.D. Pa. 1960); *Commercial Solvents Corp.* v. *Louisiana Liquid Fertilizer Co.*, 20 F.R.D. 359 (S.D.N.Y. 1957).

While the very limited discovery afforded in arbitration might be appropriate in the normal commercial situation where a panel is called on, for example, to interpret a contract or determine whether one has been performed, such limited discovery would be highly prejudicial to a fair and complete resolution of the present controversy.

As set forth above, plaintiffs' accounts were handled by both Merkin and Abraham. However, plaintiffs have no knowledge of the terms and conditions of the "arrangement" between Merkin and Abraham. Without discovery as to the defendants' relationship, plaintiffs will be greatly hampered in their preparation of the case. Discovery as to the basis for many of the representations made by defendants and the knowledge of the various defendants with respect thereto is also important to help plaintiffs establish their Rule 10b claims.

Forcing plaintiffs to submit this controversy to arbitration will substantially affect their rights under the federal securities laws and is very likely to substantially alter the outcome of this dispute. These considerations have been weighed by this court in applying the *Wilko* doctrine to violations of the Securities Exchange Act of 1934. In *Reader* v. *Hirsch & Co.*, 197 F. Supp. 111 (S.D.N.Y. 1961) the court pointed out that arbitration's many disadvantages become more apparent when it is considered as a substitute for

judicially enforced remedies for substantive violations of the federal securities laws. The court concluded:

> "[A]rbitration, whatever its merits or shortcomings, substantially affects the causes of action created. . . . The nature of the tribunal where suits are tried is an important part of the parcel of rights behind a cause of action. The change from a court of law to an arbitration panel may make a radical difference in ultimate result. *Bernhardt* v. *Polygraphic Co. of America, Inc.,* 1956, 350 U.S. 198, 203, 76 S.Ct. 273, 276, 100 L. Ed. 199." 197 F. Supp. at 116.

III.

Waiver of Rights Under The Federal Securities Laws Should Be Inferred Only In The Clearest Of Circumstances.

Defendants Abraham and Gottlieb cited to the trial court a line of cases in which certain federal courts have recognized an exception to the *Wilko* doctrine. This line of cases holds that where existing controversies are involved investors can waive their recourse to federal courts under certain circumstances. Defendants argued that by their conduct subsequent to the commencement of this dispute, the plaintiffs waived their right to judicial redress. This argument misconstrues both the *Wilko* rule and the line of cases which created the exception.

The policies behind *Wilko* are equally applicable after a dispute has arisen as before. The only difference is that once a dispute has arisen the investor has the opportunity to make an informed and reasoned determination of whether he wishes to exercise his statutory right to seek judicial redress of his grievances. Under these circumstances, there is no longer any need to protect the investor.

It is in this situation *only* that courts have found "waiver". If the investor's decision for some reason is not fully voluntary or informed, a finding of waiver would conflict with the policy behind the *Wilko* rule.

The line of cases which established the present controversy exception has found a waiver by an investor only where the investor has proceeded so far into arbitration that it is obvious he has made a final irrevocable decision to proceed with arbitration. In *Moran* v. *Paine, Webber, Jackson & Curtis,* 389 F.2d 242 (3rd Cir. 1968) and *Gardner* v. *Shearson, Hammill & Co.,* 433 F.2d 367 (5th Cir. 1970), the two cases most frequently cited for the exception to the *Wilko* rule, the courts found waiver in situations where the plaintiffs had totally completed the arbitration hearings, had awards rendered against them and appealed the awards, and thereafter sought to institute judicial proceedings.

A comparable rule has been recognized as to waiver of arbitration. The courts have held that a party waives his right under an agreement to arbitrate only if his actions are so numerous and inconsistent with his right to arbitrate, that the opposition has been prejudiced. Preliminary participation in a court case is not interpreted as a waiver. *Kulukundis Shipping Co.* v. *Amtorg Trading Corp.,* 126 F.2d 978 (2d Cir. 1942); *Robert Lawrence Company* v. *Devonshire Fabrics, Inc.,* 271 F.2d 402 (2d Cir. 1959); *Chatham Shipping Company* v. *Fertex Steamship Corp.,* 352 F.2d 291 (2d Cir. 1965):

> "The cases are altogether clear that the mere filing of an action for damages on a contract does not preclude a subsequent change in mind in favor of arbitration therein provided". 352 F.2d at 293.

Two Second Circuit cases cited by defendants to the trial court do not support a finding of waiver. Both cases are

distinguishable, both on their facts and in the policy considerations applied by the courts.

In *Coenen* v. *R. W. Pressprich & Co.*, 453 F.2d 1209 (2d Cir. 1972) the court held that a plaintiff who became a member of the New York Stock Exchange after a controversy had arisen was bound by the Exchange's rule requiring arbitration of all disputes between its members. The court gave two reasons for deciding that such an agreement to arbitrate a securities violation was valid. First, the court pointed out that Coenen agreed to arbitrate after the dispute had arisen. The only authorities cited by the court were the *Moran* v. *Paine, Webber, Jackson & Curtis, supra,* and *Gardner* v. *Shearson, Hammill & Co., supra,* which as mentioned above found waiver only after the plaintiffs had fully participated in a complete arbitration hearing.

Second, and more importantly, the Second Circuit noted that *Coenen* involved totally different policy considerations than *Wilko*. *Wilko* involved a dispute between an investor and a broker, while *Coenen's* dispute was between members of the New York Stock Exchange. 453 F.2d at 1213. The Coenen court expressly noted that the overriding policy in favor of protecting investors found in the federal securities laws was not involved in a dispute between brokerage houses. The court emphasized this difference by quoting from its previous opinion in *Axelrod & Co.* v. *Kordich, Victor & Neufeld,* 451 F.2d 838, 842-43 (2d Cir. 1971):

> "[T]he policy considerations relied on by the Supreme Court in *Wilko* are inapposite here. The Supreme Court found that the non-waiver provision there involved was designed to protect investors. [Citations omitted.] Without such provision, financial houses might escape statutory liability by taking advantage of the inferior bargaining position of customers. But the legislative policy of protecting investors will not be thwarted by compelling an exchange member to arbitrate. . . ."

Furthermore, the *Coenen* holding requiring arbitration was supportive of another express statutory policy. Section 28(b) of the Securities and Exchange Act of 1934 specifically states that the Act is not intended to modify the law concerning the power of Securities Exchanges to settle disputes between their own members.

The *Coenen* court also found that plaintiff had waived his right to litigate the alleged antitrust violations because of his agreement to arbitrate the existing dispute. The court explained the rationale for its decision by analogizing an agreement to arbitrate an existing dispute to an agreement to settle an existing dispute, reasoning that if a person can decide to settle a dispute he can decide to have it settled by a third party, an arbitrator.

This reasoning is entirely consistent with the rule that waiver should be inferred only in the clearest of circumstances. Since an agreement to settle will be inferred only if a party's conduct clearly evidences such an intent the same standard should be applied to waiver of a party's rights under the securities laws. *Cobb* v. *Lewis*, 488 F.2d 41 (5th Cir. 1974).

The second case cited by defendants to the trial court, *Lawson Fabrics, Inc.* v. *Akzona, Inc.*, 355 F.Supp. 1146 (S.D.N.Y. 1973), *aff'd mem.*, 486 F.2d 1394 (2d Cir. 1973), is also inapplicable. The agreement to arbitrate in *Lawson* did not involve a dispute under the federal securities laws. Indeed, the *Lawson Fabrics* court pointedly observed that the three statutes involved—the Lanham Act, the Federal Trade Commission Act, and the Textile Fiber Products Identification Act—did not contain language similar to that found in the federal securities laws prohibiting waiver by a party of its statutory rights. 355 F.Supp. at 1149. The *Lawson Fabrics* court queried whether the three statutes involved sufficient public interest

in judicial enforcement to justify application of the *Wilko* doctrine, but based its decision on the ground that after the dispute arose the plaintiff, Lawson, voluntarily initiated the arbitration proceedings. The facts in the present case are completely different. Here, the broker Abraham initiated the arbitration proceedings, forcing the plaintiff investors to respond by designating a forum within the time frame established in the arbitration clause of the customer's agreement. (Letter dated June 20, 1974, Abraham to plaintiffs, 82A.) The formal demand for arbitration was initiated by Abraham, not by plaintiffs. (37A *et seq.*) The plaintiffs then countered by offering to submit the entire controversy *involving both defendants* to arbitration in a single proceeding. (46A *et seq.*). Plaintiffs' counteroffer was opposed by Merkin. The plaintiffs have never agreed to an arbitration involving Abraham alone.

Accordingly, *Lawson Fabrics* is distinguishable on two clear grounds: it did not involve violations of the securities law; and, it did involve arbitration proceedings voluntarily initiated by the party who later sought to reverse his position and take the matter to court.

The most complete and well-reasoned analysis of the conduct necessary to support a finding of waiver was recently handed down by the Fifth Circuit in *Cobb* v. *Lewis,* 488 F.2d 41 (5th Cir. 1974). *See also American Safety Equipment Corp.* v. *J. P. Maguire & Co.,* 391 F.2d 821 (2d Cir. 1968).

In *Cobb* the court was dealing with the closely analogous area of waiver of the right to litigate an issue arising under the federal antitrust laws. The court found that on December 15, 1971, soon after a dispute arose, the plaintiff was served with a demand for arbitration. On December 28th plaintiff asked for an extension of time for filing an answer and counterclaim in the arbitration proceeding.

The requested extension was granted and plaintiff filed his answer and counterclaim on January 17, 1972. This counterclaim mentioned the antitrust claim for the first time. On January 24th plaintiff requested that the American Arbitration Association appoint a panel of three arbitrators. On January 25th, the plaintiff notified all parties that he was rejecting the arbitration proceedings. Soon thereafter plaintiff commenced his federal action.

Just as in the present case, the defendant asked the court to infer waiver from plaintiff's participation in the arbitration proceeding. The Fifth Circuit approved the Second Circuit's rationale in *Coenen, supra*, to the effect that the parties could enter into a binding agreement to arbitrate *existing* disputes on the same basis that they could agree to settle such disputes. The court agreed that a *de facto* agreement could be implied from a party's participation in arbitration, but held that such conduct had to be sufficiently substantial to clearly show that the party had made a willing and informed choice to waive federal litigation. The court explained:

> "What is required is that the party's conduct evidence in some way that the party has made an informed, deliberate, and explicit decision to have his antitrust claims arbitrated, comparable to the kind of decision which would be represented either by a decision to settle or by a decision to enter into an express agreement to arbitrate. We think that this test is necessary to fulfill the underlying policies favoring judicial disposition of antitrust issues." 488 F.2d at 49.

Of course, the same policies exist with respect to judicial disposition of disputes arising under the securities laws.

The court then applied this standard to the facts and ruled that no waiver had occurred. The court stated that

plaintiffs' actions did not establish the required "eye-open choice" of forum.

For the same reasons, no "eye-open choice" has been made by plaintiffs in the present case. To find, as defendants have contended, that the actions involved herein constitute a waiver of plaintiffs' right to litigate in the federal courts would reduce the existing controversy exception to the *Wilko* doctrine to a concept of "gamesmanship". Defendants would have the courts look to the form of the parties' actions, without analyzing the parties' true intentions.

To hold that these plaintiffs waived their valuable rights to litigate important controversies involving the seminal policies of the federal securities laws, would do violence to the spirit and the letter of the law enunciated by the United States Supreme Court in *Wilko* v. *Swan, supra.*

CONCLUSION

For the foregoing reasons, the decision of the trial court on the motion of defendants Abraham and Gottlieb for an order staying this litigation and compelling plaintiffs to arbitrate the present dispute should be vacated and these proceedings should be continued forthwith.

Respectfully submitted,

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Service of two (2) copies of

the within Brief is hereby admitted this

21st day of [illegible], 1976

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